No. 11,029

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

UNITED STATES OF AMERICA,
Appellant,

vs.

LA SOCIETE FRANCAISE DE BIENFAISANCE MUTUELLE (a corporation),
Appellee.

On Appeal from the District Court of the United States for the Northern District of California.

BRIEF FOR THE UNITED STATES.

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OPINION BELOW.

The opinion of the District Court (R. 29-37) is reported in 57 F. Supp. 201.

JURISDICTION.

This appeal involves federal social security taxes, penalties and interest. The taxes, penalties, and interest in dispute were assessed for the calendar years 1936 to 1942, inclusive. The aggregate amount involved is $35,269.85. Payments thereof were made in

various amounts and upon various dates during the years 1939 to 1942, inclusive. (R. 12-15.) Separate claims for refund of each of the payments of taxes, penalties and interest were filed on August 3, 1943 (R. 15-16), and were rejected by notice dated October 26, 1943. (R. 16-17.) Within the time provided by Section 3772 of the Internal Revenue Code and on November 23, 1943, the taxpayer brought an action in the District Court for recovery of the taxes, penalties and interest paid. (R. 2-18.) Jurisdiction was conferred on the District Court by Section 24, Twentieth, of the Judicial Code, as amended. The judgment was entered on October 13, 1944. (R. 56-58.) Within three months and on January 9, 1945, a notice of appeal was filed (R. 58), pursuant to the provisions of Section 128(a) of the Judicial Code, as amended.

QUESTION PRESENTED.

Whether taxpayer is a charitable corporation within the meaning of Section 811(b)(8) of Title VIII and of Section 907(c)(7) of Title IX of the Social Security Act and of the corresponding provisions of the Internal Revenue Code.

STATUTES AND REGULATIONS INVOLVED.

These will be found in the Appendix, *infra,* pp. i-iv.

STATEMENT.

The facts, as found by the District Court, are substantially as follows (R. 37):

Taxpayer was incorporated in 1865 under Chapter VIII (relating to "Religious and other Associations or Societies") of the California Corporation Act of 1850. It succeeded an unincorporated beneficial society of the same name which had been founded in 1851. Its residence and place of business has always been at San Francisco, California. Its sole purpose has always been the care and treatment of the sick without profit, and to that end it has always maintained a non-profit hospital. (R. 38.) Taxpayer has never had any capital stock and has never paid dividends or other distributions to any one. (R. 38.) No part of its net earnings has ever inured to the benefit of any private shareholder or individual. (R. 38-39.) The corporation's affairs have been managed by a board of directors, elected annually by the members of the society, who serve without compensation. (R. 39.)

Taxpayer has acquired its present hospital plant and facilities largely through testamentary and other gifts. Receipts from members would not have been sufficient therefor. Assets acquired by taxpayer in 1856 from its predecessor largely consisted of charitable gifts. Legacies and gifts since 1851 exceed $360,000. On February 29, 1944, the close of taxpayer's last fiscal year, a reserve of $221,627.76 was carried on its books, of which $76,783.87 was made up of gifts and $114,836.89 represented its depreciation fund. (R. 39.) Under the corporation's by-laws

the reserve is set aside for enlargement and improvement of its plant and facilities. (R. 39-40.)

Prior to 1895, taxpayer owned and operated a general hospital. In and after 1894 it erected and has since owned and operated a general hospital. The plant now comprises eleven buildings located on a city block of land in San Francisco owned by taxpayer. The hospital has a capacity of 225 beds and a nursery of fifteen cribs. It is open to the public at large without any distinction. It is approved by the American Medical Association and American College of Surgeons as a "Class A" hospital. (R. 40.) In the fiscal year 1944 the average daily number of hospitalized patients was 189.71—the average number for the last eight years was about the same. (R. 40.) In 1944 the number of days treatment given to all hospitalized patients was 69,437 and for the eight year period the average number for 64,222. During the same periods the number of consultations granted to members at the hospital, or calls on members by the medical staff, averaged annually about 26,000. (R. 40-41.)

Since 1895 taxpayer has maintained a nurses' training school at an annual cost of about $12,000. It maintains a building used exclusively as a training home for nurses. Usually sixty or seventy student nurses are in training. (R. 41.) There are also usually at least six internes in training at the institution. (R. 41.)

Taxpayer maintains in the hospital an old people's home for the care of aged or sick members, with a

capacity of fifteen beds. Such persons are admitted at the discretion of the board of directors and they pay according to ability, but not upon fixed schedules or any profit making basis. (R. 42.)

Taxpayer affords other charitable relief—providing two permanent free beds for indigent patients (R. 42) and providing free emergency treatment if necessary to all deserving cases in its neighborhood. (R. 42-43.)

The number of members is not limited; it has arranged about 9800 during the taxable periods involved. Taxpayer never solicits members and has never paid any commission to obtain new members. It has only one class of members who pay monthly dues of $1.75, except life members who pay flat sums upon admission and children of members who pay one dollar monthly. (R. 43.) Continued payment of dues is not necessarily a condition to relief. At the discretion of the board indigent widowed or orphaned members are furnished free treatment and facilities. (R. 43.)

During the periods involved in this action members were entitled to benefits without charge or at a discount as follows: Medical and surgical consultations without charge at or outside the hospital; hospitalization without charge, including operating room, drugs, dressings, and board and room up to six months in any one year, except for a charge of fifty cents per day for ward patients and a charge of about fifty per cent of prevailing rates for private room hospitalization; special discounts from ten to ninety per cent of prevailing rates on drugs, dressings, x-ray examinations and treatments and in obstetrical cases. (R. 44.)

The expense of operation and maintenance and improvement of the hospital facilities is derived from (1) members' monthly dues; (2) admission fees of new members $25 and upwards, according to age; (3) income from investments; (4) donations and bequests; (5) life membership fees; (6) special fees from life boarders; and (7) receipts from non-member hospitalized or treated patients. (R. 44-45.) Receipts in any year in excess of expenses are credited to a surplus accumulated to further taxpayer's purposes; deficiencies in any year are paid from surplus. (R. 45.)

There has been no change in taxpayer's plan of operations since long prior to 1936. On July 14, 1937, the then Deputy Commissioner of Internal Revenue officially notified taxpayer that it was exempt from payment of taxes imposed by the Social Security Act inasmuch as it came within the exception provided in Section 811(b)(8) of Title VIII and Section 907(c)(7) of Title IX, and further that it was entitled to exemption under the provisions of Section 101(6) of the Revenue Act of 1936. (R. 45.) On February 24, 1939, the then acting Commissioner of Internal Revenue notified taxpayer that while it appeared that the corporation was not operated for profit and did engage in substantial charitable activities, it was nevertheless not entitled to exemption from income taxes under the provisions of Section 101(6) of the Revenue Act of 1938 as a corporation organized and operated exclusively for charitable purposes, and that the ruling contained in the Bureau letter dated July 14, 1937,

was modified accordingly. (R. 45-46.) Thereafter on April 3, 1939, the Deputy Commissioner of Internal Revenue notified taxpayer, referring to the communication of February 24, 1939, that it was not entitled to exemption under Section 811(b)(8) of Title VIII and Section 907(c)(7) of Title IX of the Social Security Act. (R. 46.)

After receipt of the Bureau ruling of July 14, 1937, taxpayer refunded to its employees all the contributions which theretofore had been deducted from their wages and made no further deductions until the ruling was reversed by the letter dated April 3, 1939. Taxes, penalties and interest later paid for that interval were paid exclusively from taxpayers' funds without any deductions from employees' wages. (R. 46.)

The findings then set forth the amounts and dates of payments of social security taxes, penalties and interest involved in the action. The aggregate amount paid was $35,269.85. (R. 47-50.) The Collectors to whom payments were made are not in office (R. 50) and accordingly the action was properly brought against the United States.

On August 3, 1943, the taxpayer filed claims for refund of all the social security taxes, penalties and interest involved in this action, which were paid for the calendar years 1936 to 1942, inclusive. (R. 50-51.) The grounds for the claims are set forth in full. Taxpayer claimed exemption from the taxes as a charitable corporation. (R. 51-54.) On October 26, 1943, the Commissioner of Internal Revenue notified the

taxpayer that the claims were disallowed on the ground that it was "an organization organized exclusively for social welfare" and was not a "corporation organized and operated exclusively for charitable purposes." (R. 54.)

Upon the above findings the District Court concluded that the taxpayer since August 14, 1935, the effective date of the Social Security Act, has been a charitable corporation within the meaning of Section 811(b)(8) of Title VIII and Section 907(c)(7) of Title IX of the Act and corresponding sections of the Internal Revenue Code, and that taxpayer is entitled to judgment for the taxes, penalties and interest paid, with interest from the dates of payments and its costs of suit. (R. 54-55.)

It is not noted in the findings but the by-laws provide that any person of French birth, or descendant of French or speaking French, sound in mind and body may be admitted to membership in the Society. (R. 91.) The qualification with respect to speaking French has been liberally construed. (R. 137.)

SUMMARY OF ARGUMENT.

In order to be held exempt from taxation as a charitable corporation the taxpayer must establish (1) that it was organized exclusively for charitable purposes (2) that it was operated exclusively for charity and (3) that no part of its net earnings inure to the benefit of a private individual.

The taxpayer's by-laws state "The Society is founded on the basis of mutuality for the treatment of sick members;". Thus it appears that the corporation was organized for the mutual benefit of its members, not for charity. This distinction has been noted by the courts and text-writers. Organizations of the nature of mutual benefit associations have been denied exemption as charities.

The taxpayer, through its hospitals has engaged in some charitable activities. But these functions were merely incidental to its main purpose, the mutual benefit of its members by obtaining for them cheaper and better medical treatment and facilities than would otherwise be available. Classification of organizations, for tax purposes, depends on their main features not incidental activities.

The taxpayer was not organized to receive and dispense charity. The by-laws provided for monthly dues from the members for treatment and charges for hospitalization. Much higher rates for hospitalization were provided for non-members. The by-laws provide that the Society may receive donations. It has received gifts and legacies from the time of organization, but for the last nine years the amounts thus received have been only one per cent or less of its gross income. The amounts received from members are not gifts, but are payments made for which the members receive contractual rights to specified medical treatment and hospitalization. The amounts contributed by non-members were in payment for services rendered. The amounts expended by the Society for concededly char-

itable purposes were very small compared to total disbursements.

The taxpayer has no shareholders and has never distributed dividends. But earnings may inure to individuals in other ways than dividends. In this case the members benefited from the earnings of the Society and its hospital through low rates, better service and facilities made available through profits on payments made by non-members.

In another case an organization which collected dues from subscribers and contracted with hospitals for treatment of members when needed was held not exempt because of inurement of benefits to members through lower rates obtained by the group plan. This case is stronger for the Government. The members of the French Society obtained the benefits inuring to them through the group or mutual benefit plan, and additional benefits from profits made by its own hospital. If the hospital had been operated solely as an eleemosynary organization, the Society itself would be taxable, nevertheless, because of inurement of earnings to the benefit of members.

Congress did not intend to exempt organizations like the taxpayer as charitable corporations. The section of the Social Security Act here involved is exactly like Section 101(6) of the Internal Revenue Code and similar sections in prior Revenue Acts. But the income tax law differs from the Social Security Tax in one important respect in addition to exempting charitable organizations of the general class of mutual benefit, fraternal, cooperative building and growers,

etc., associations. None of these specific exemptions are mentioned in the Social Security Act. The fact that Congress specifically mentioned such organizations in the income tax law indicates that they were not considered within the scope of charitable organizations. Since the taxpayer closely resembles many of the organizations specifically mentioned, Congress could not have intended it to fall within the scope of a corporation organized and operated exclusively for charitable purposes.

The opinion of the Attorney General relied upon by the District Court is not applicable here. The Attorney General held that a non-profit hospital was exempt. There was no organization of the nature of a mutual benefit association, like the taxpayer, involved; no preferential rates were given by the hospital to any group; and the question of inurement of earnings or benefits to individuals was not an issue.

ARGUMENT.

I.

THE TAXPAYER IS NOT A CHARITABLE CORPORATION WITHIN THE MEANING OF THE APPLICABLE STATUTES.

The taxpayer claims exemption from liability for social security taxes on the ground that it is a charitable corporation. Under the terms of the applicable statutes (Sections 811(b)(8) and 907(c)(7) of the Social Security Act and Sections 1426(b)(8) and 1607(c)(7) of the Internal Revenue Code) in order to be held exempt the taxpayer must establish:

(1) that it was organized exclusively for charitable purposes

(2) that it is operated exclusively for charitable purposes and

(3) that no part of its net earnings inure to the benefit of private shareholders or individuals. See Section 1426(b)(8) of the Internal Revenue Code, Appendix, *infra.*

A. The taxpayer was not organized exclusively for charitable purposes and it is not operated in that manner.

The first approach in determining the reason for organization of a corporation should be an examination of its charter powers and purposes and its by-laws. The purpose of an organization must be determined from the purpose declared in the instrument creating it. *Northwestern Municipal Ass'n v. United States,* 99 F. (2d) 460, 461 (C.C.A. 8th); S*mith v. Reynolds,* 43 F. Supp. 510, 514 (Minn.). It was said in *Helvering v. Coleman-Gilbert Associates,* 296 U.S. 369, 374:

> The parties are not at liberty to say that their purpose was other or narrower than that which they formally set forth in the instrument under which their activities were conducted.

The charter of the taxpayer is not in the record. However, the following appears in the by-laws of the French Mutual Benevolent Society, adopted March 23, 1902 (R. 119):

ARTICLE II

Purpose of the Society

The Society is founded on the basis of mutuality for the treatment of sick members; * * *

Thus it appears that the Society was organized for the mutual benefit of its members, not for charitable purposes.

In *Smith v. Reynolds, supra,* the court said (pp. 513-514):

> There can be little question but that a voluntary association for the mutual benefit of its members may, without difficulty, be distinguished from a public charitable institution. These distinctions have been considered by the Courts and textwriters. See: *Coe v. Washington Mills et al.,* 149 Mass. 543, 21 N. E. 966; *Young Men's Protestant, etc., Society v. City of Fall River,* 160 Mass. 409, 36 N. E. 57; 11 Corpus Juris, p. 305; 14 C.J.S., Charities, Sec. 2; 7 Corpus Juris, 1051; 10 C.J.S., Beneficial Associations, Sec. 1; 19 Ruling Case Law, 1182, section 5.
>
> It clearly appears that the Association was organized for the mutual benefit of its members. There is no evidence that it departed from the purposes for which it was organized, nor is there any evidence that it carried on the usual activities of a charitable institution. To be entitled to the exemptions granted by either of the statutes under consideration, an association must be organized and operated exclusively for charitable purposes, with no part of the net earnings accruing to the benefit of its members. It is the general rule of law that the objects and purposes of

an organization must be determined from the purposes and objects as declared in the instrument creating it. *Helvering v. Coleman-Gilbert Associates,* 296 U.S. 369, 56 S. Ct. 285, 80 L. Ed. 278. The objects of the Association set out in its constitution are stated specifically as being the operation of hospitals for the care and treatment of its members, with the privilege of taking into such hospitals such other persons as may be admitted, as pay patients under certain conditions. There is no indication in its articles that its hospitals were to be conducted as charitable institutions. There is nothing in the evidence to indicate that the major part of the activities of the Association were charitable or benevolent. True, some charity cases were taken care of, but that fact does not in itself make the Association a charitable organization.

In *Coe v. Washington Mills,* 149 Mass. 543, 547, it was held:

> To constitute a public charity, there must be an absolute gift to a charitable use for the benefit of the public. In this case the contributions of the members were not gifts for a charitable use for the benefit of the public, but they were payments for their own advantage * * *. Each member paid a regular fee or assessment, and in consideration thereof he became entitled to a certain benefit in case of sickness or accident, as a personal right. * * *

In Zollman's American Law of Charities, the following statement is made with respect to charities (pp. 143-144):

Mutual benefit societies exist in great numbers and, as their name indicates, are of much benefit to their members. The fact that payments made to them are made for the advantage of their members rather than for the benefit of the public, makes them insurance societies, and excludes them from classification as public charities. Since their benevolence begins and ends at home, they will not receive recognition as charities though they may contemplate the occasional exercise of charity, and though they aim at the suppression of vice and immorality and at the inculcation of every virtue that renders man noble, great and happy. The question is not whether they may, but whether they must, apply their property to charitable purposes. While their purposes are worthy and benevolent, they are at most private charities, and can lay no claim to any rank as public charities.

In *Philadelphia & Reading Relief Ass'n v. Commissioner,* 4 B.T.A. 713, 728, it was said:

Here, for definite contributions, paid by its members at regular recurring periods, the Association undertakes to pay its members certain definite sums in the event of sickness, accident, or death. Whatever it may be called, the scheme is that of insurance. The relation of the Association to its members is contractual, rather than charitable. Nor is it a benevolent institution. No aid is furnished from generosity or liberality. None such is pretended. On the contrary, for a pecuniary consideration the Association agrees to pay a definite sum in the cases specified. If it fails to perform its contracts with its members,

> they may be enforced in the courts by suit. Certainly, under circumstances such as we have present in this case, it can not be successfully maintained that petitioner is a corporation or association, organized and operated exclusively for charitable purposes, and, hence it is not entitled to exemption from tax under the provisions of section 231(6) of the Revenue Act of 1918.

See also *Employees Benefit Ass'n of Amer. Steel Foundries v. Commissioner,* 14 B.T.A. 1166; *Pontiac Employees Mutual Benefit Ass'n v. Commissioner,* 15 B.T.A. 74; *Donnelly v. Boston Catholic Cem. Ass'n,* 146 Mass. 163; *Hassett v. Associated Hospital Corp.,* 125 F. (2d) (C.C.A. 1st), certiorari denied, 316 U.S. 672.

The taxpayer, through its hospital, has engaged in some charitable activities. The District Court found that it maintains fifteen beds for aged or sick members who are admitted at the discretion of the board of directors and who pay according to ability; it provides two permanent free beds for indigent patients (R. 42); and it provides free emergency treatment if necessary to all deserving cases in its neighborhood (R. 42-43). However, these functions appear to have been merely incidental to the main purpose of the Society which, we contend, was to obtain for its members cheaper and better medical care, treatment and facilities than would otherwise be available to them and at a lower rate than the facilities of the hospital operated by the Society are afforded to the public. Classification of an organization as charitable or non-

charitable, at least for the purposes of taxation, depends on its main features, not incidental activities. *Trinidad v. Sagrada Orden,* 263 U.S. 578; *In re Kennedy's Estate,* 269 N.Y.S. 136, affirmed without opinion, 264 N.Y. 691; *Smith v. Reynolds, supra.*

The taxpayer was not organized to receive and dispense charity. There is no indication in the by-laws of the Society that its hospital was to be conducted as a charitable institution. To the contrary it is provided that non-members shall pay a minimum of three dollars per day in the wards and five dollars and up per day in private rooms (R. 108). The members pay fifty cents per day for hospitalization in the wards and about fifty per cent of the amounts paid by outside patients for private rooms. (R. 44, 72.) The by-laws also provide that after six months a member shall pay a minimum of two dollars per day over the actual rates then in effect. (R. 105.)

The by-laws provide that the Society may receive donations which will be used as much as possible to conform with the wishes of the donor. (R. 101.) The District Court found that legacies and gifts to the Society exceed $350,000, without which it could not have acquired its present plant and facilities. (R. 39.) However, as the California District Court of Appeal noted in *La Societe Francaise v. Cal. Emp. Com.,* 56 Cal. App. (2d) 534, 540, certiorari denied, 320 U.S. 736, the amounts received by the Society for the five year period ended February 29, 1940, as legacies, gifts and donations, amounted to only approxi-

mately one per cent of its gross income. The proportion has been ever smaller in the subsequent years, including 1944. (R. 154.)

The amounts paid by the members as admission fees, monthly dues, and for special services were not gifts. In discussing a similar situation in *Smith v. Reynolds, supra,* the court said (p. 513):

> Here the Railway Company has made appreciable contributions to the Association each year. These were gifts on the part of the Railway Company, but are the payments made each month, by the members of the Association, gifts? I think not. Under the constitution and by-laws of the Association, these monthly payments by the members purchase and entitle them to certain benefits —medical care and attention, hospitalization and nursing, in case of injury or sickness; and in the event of the death of a member, a burial benefit is provided for. The member is entitled to the benefits as a matter of right, so long as he pays the dues required of him. But if he should fail to pay the monthly assessment or dues, his membership in the Association is automatically forfeited, along with any rights to the benefits provided for in the by-laws.

In passing on like contentions as are here made, the Board of Tax Appeals, in *Appeal of Philadelphia & Reading Relief Association,* 4 B.T.A. 713, 728, had this to say: "Here, for definite contributions, paid by its members at regular recurring periods, the Association undertakes to pay its members certain definite sums in the event of sickness, accident, or death. Whatever it may be called, the scheme is that of insurance.

> The relation of the Association to its members is contractual, rather than charitable. Nor is it a benevolent institution. No aid is furnished from generosity or liberality. None such is pretended. On the contrary, for a pecuniary consideration the Association agrees to pay a definite sum in the cases specified." See also *Hassett v. Associated Hospital Service Corporation of Massachusetts,* 1 Cir., 125 F. (2d) 611, reversing D. C., 37 F. Supp. 822.

In the *Hassett* case, *supra,* the court held (p. 614):

> The payment of a fee is a prerequisite to the receipt of benefits and the relationship existing between the corporation and the subscriber is contractual. The subscribers consider themselves neither charitable donors nor the recipients of charity.

It hardly need be said that the paying patients are not the objects of charity. As the name implies they paid for what they got. If common experience prevails those patients certainly do not consider themselves the recipients of charity. In this case also the by-laws provide that any member six months in arrears in the payment of his dues is stricken from the rolls. (R. 94.) See also *In re Hinckley,* 58 Cal. 457; *In re Sutro's Estate,* 155 Cal. 727; *In re Kennedy's Estate, supra.*

It has been noted above that the amounts of gifts and legacies received by the taxpayer, at least during the taxable periods involved, were insignificant in comparison with its gross income. Therefore, it can-

not be said that the Society is a charitable organization in the sense that is in any substantial degree supported by charity. On the other hand it is equally clear that the Society dispensed but little for charity. The amounts expended for the concededly charitable functions, such as the two free beds, emergency treatments, etc., are not specified in the record. Obviously, however, such amounts must have been comparatively small in comparison to total disbursements. The evidence demonstrates that, far from being operated *exclusively* for charity, as the exempting statute would require, the Society was operated *almost* exclusively as a non-charitable business organization.

B. The taxpayer is not a corporation, no part of the net earnings of which inure to the benefit of private individuals.

Corporations cannot qualify for exemption as charitable organizations if any part of their net earnings inure to the benefit of private shareholders or individuals. Section 1426 (b)(8) of the Internal Revenue Code. This corporation has no shareholders. (R. 38.) But the members of the Society are individuals within the meaning of the statute. In discussing the meaning of the term it is stated in 3 Paul and Mertens, Law of Federal Income Taxation, Sec. 32.17, pp. 579-580:

> The statute expressly provides as a requisite to exemption that no part of an organization's net earnings shall inure to the benefit of private shareholders or individuals. The words "private shareholder or individual" refer to "individuals having a personal and private interest in the ac-

> tivities of the corporation." Earnings do not inure to the benefit of a stockholder or individual when they inure to him merely as one of the public and in other than his private capacity. This test is independent of the other tests; it operates regardless of the fact that the purposes may be religious, educational or literary. * * *
>
> The persons receiving the benefit of the work and operations of an organization exempt under this classification must form a substantial group of the general public. An association or organization whose charities are for the mutual assistance of its own members and families is not generally regarded as charitable. * * *

The taxpayer has never paid any dividends to anyone. (R. 38.) But it is well established that profits may inure to the benefit of shareholders in other ways than in dividends. *Northwestern Municipal Ass'n v. United States,* 99 F. (2d) 460, 463 (C.C.A. 8th); *Smith v. Reynolds,* 43 F. Supp. 510, 514 (Minn.); *Northwestern Jobbers' Credit Bureau v. Commissioner,* 37 F. (2d) 880, 883 (C.C.A. 8th). See also *Uniform Printing and S. Co. v. Commissioner,* 33 F. (2d) 445 (C.C.A. 7th); *In re Farmers' Union Hospital Ass'n of Elk City,* 190 Okla. 661.

We believe that the court below erred in finding that no part of the net earnings of the Society inured to the benefit of any private individual (R. 38-39) and in holding in the opinion (R. 33-34):

> Following the same reasoning, the fact that the members benefit from the use of the hospital should not alter its character as a non-profit hos-

> pital. The members pay for the service they receive. The public, of course, pays higher rates for hospitalization than the members, for it has not contributed monthly payments to the hospital. But there is no showing that the members receive less costly treatment at the expense of the public or that the amount of dues charged is not commensurate with the cost of treating the membership as a whole. The proof shows that in the eighty-seven years of its history, plaintiff has occasionally made a profit, has sometimes come out even, and has more often sustained a deficit. When profits are made or charitable donations received, both the membership and the public benefit by the improvements in hospital facilities made possible thereby.

As shown above, the charitable donations were insignificant. The profits of the Society were from payments for hospital services to non-members. It is obvious that there were profits from that source, else it would not have been possible for the Society to furnish services to its members at rates far lower than charged to non-members. If the amount of dues charged were commensurate with the cost of treatment of the membership as a whole, then there would seem to have been no justification or need for charging non-members higher rates for hospitalization.

We submit that the profits of the hospital operation do inure to the benefit of the members. This taxpayer brought actions in the California courts to recover sums paid under the California Unemployment Insurance Act (California Statutes (1935), c. 352, p.

1226; California General Laws (1937), Act. No. 8780 d, p. 4121). The opinion of the District Court of Appeal in the consolidated actions shows that the evidence and the contentions of the parties there were substantially identical with those presented in this case. *La Societe Francaise v. Cal. Emp. Com.,* 56 Cal. App. (2d) 534. It was held (p. 538, 540, 543):

> Plaintiff contends that it is a corporation organized and operated exclusively for charitable purposes, and that no part of its net earnings inures to the benefit of any private shareholder or individual within the meaning of section 7 (g) of the California Unemployment Insurance Act; that, since the provisions of said section 7 (g) of the state act are adopted from the federal Social Security Act and other federal tax statutes, this court must look to "the general understanding throughout the country" for the construction of the terms employed in section 7 (g); and that under such "general understanding," the appellant is *per se* a charitable institution.
>
> The defendant contends on the other hand that the plaintiff is not a corporation organized and operated exclusively for charitable, scientific or educational purposes, and that its earnings, or a portion thereof, do inure to the benefit of private individuals, inasmuch as the members of plaintiff receive hospitalization and other medical treatment and care, on payment of rates far lower than those charged to non-members, which preferential treatment is made possible only because plaintiff derives a profit from its services so rendered to non-members.
>
> * * * * * * *

As found by the court, any profits, gains or net earnings accruing "from plaintiff's operations are devoted and applied to the better and more ample care of its members and for the furnishing to said members of said medical, hospital and other benefits and privileges prescribed and contemplated by said bylaws, and that such profits, gains and earnings are not in any form or manner distributed or paid to anyone as dividends or interest. * * * That the earnings of plaintiff arising from the furnishing of hospital and other facilities and services to individuals who are not members of plaintiff, at rates, fees or charges in excess of those applicable to members, inure to the benefit of plaintiff's members only in the sense that such earnings have been and are used to enable plaintiff, as hereinabove found, to give better and more ample and augmented service, privileges and benefits to plaintiff's members."

* * * * * * *

The vital question on this appeal is, did any of appellant's net earnings inure "to the benefit of any private shareholder or individual?" (Section 7g.) The facts heretofore stated demonstrate that while no profits or dividends are distributed, nevertheless the net earnings of appellant arising from its hospital facilities, and services to "non-members" at rates in excess of those generally charged members inure to the benefit of the members in augmented service and privileges which would not be available to them but for the added "outside" sources. In other words, appellant is not "exclusively" a charitable organization.

It is to be noted that the amount of income to the hospital from non-members has always been very substantial. From 1937 through 1940 the aggregate amount paid by non-members for hospitalization was two to three times that paid by members. From 1941 through 1944 the proportion has greatly increased so that in 1944 non-members paid more than ten times as much as members. From 1937 through 1940 the total amount paid by members (for admission fees, dues, etc., as well as hospitalization) was in the ratio of about five to three to that paid by non-members for hospitalization only. From 1940 through 1944 the ratio has been gradually reversed until, as shown in taxpayer's "Exhibit No. 7", in 1944, non-members paid more than twice as much for hospitalization alone as the members did for all services. (R. 154.)

From the profits through hospitalization the Society was able to carry on some purely charitable activities. But it is apparent that by far the greater part of the profits went to the benefit of the members. The admission fees and dues of the *members* remained low; hospitalization was afforded the *members* at a nominal charge; at the discretion of the board of directors the Society could furnish free treatment and facilities to indigent widowed or orphaned *members*; and could continue to serve some indigent *members* in default of dues. (R. 43.) This view is supported rather than refuted by the District Court's holding (R. 33): "The proof shows that in the eighty-seven years of its history, plaintiff has occasionally made a

profit, has sometimes come out even, and has more often sustained a deficit." Aside from its reserve fund for building and improvement of facilities (R. 39-40), it does not appear that the Society had any reason to accumulate money, it could not distribute cash to anyone, but its profits could be and were used largely for the benefit of members through low rates and improved services and facilities.

The District Court relied upon the case of *United States v. Proprietors of Social Law Library,* 102 F. (2d) 481 (C.C.A. 1st), which was distinguished in the *Hassett* case, *supra.* (R. 32-33, 35-36.) There the corporation was held exempt from the capital stock tax under the provisions of Section 101 (6) of the Revenue Act of 1934, which corresponds to the exempting statute involved in this case. The Social Law Library was chartered in Massachusetts in 1814 as a charitable or educational institution. It is housed free in the Suffolk County Court House and receives $1,000 annually from the County. Its facilities are open to all who become "Proprietors", and free of charge to certain state and federal officials. It was operated exclusively for educational purposes and it was held that the public benefited directly and indirectly through better administration of the law by reason of knowledge obtained by those entitled to use the library. Its earnings were used to improve its facilities, but the court held that fact did not take the institution out of the classification as an educational organization. There are points of similarity in the cases. But the vital one is lacking—the proprietors

did not benefit at the expense of outsiders. The same rate was paid by all proprietors. Moreover, the general public received direct benefits from the operation of the library, which can hardly be said with respect to the French Society.

In the *Hassett* case, *supra,* the subscribers paid fees to an organization which contracted with hospitals to provide certain care to the members when needed. Thus through the group plan the members received care in cases of sickness or accident at low rates. The Circuit Court of Appeals held that the organization was similar to a mutual insurance company or an employee benefit plan. On that basis it was denied exemption as a charitable corporation. The court distinguished the *Social Law Library* case on the ground, among others, that the corporation in the case at bar (the hospital contracting organization) was more akin to a business organization than the one involved in the *Social Law Library* case. The court below quotes the *Hassett case,* with approval, but points out that the corporation there did not own or operate a hospital. We believe that very fact strengthens rather than weakens the Government's position in this case. Had the French Society merely collected dues from persons of French nationality or descent and then in turn obtained for them medical treatment and hospitalization at low rates at outside hospitals, it would not be exempt, under the *Hassett* decision. But the Society gained for its members the greater advantages discussed above through operating its own hospital. It would certainly violate the statute to

grant exemption to the corporation as a charity if we are correct in the view that operation of the hospital by the Society merely enhanced the inurement of benefits to its members.

This leads to the final point that we desire to urge in this part of the argument. Of course, we do not concede that the French Hospital was operated as a charitable corporation, entitled to exemption from social security taxes. But even if it were the Society itself, which is the employer here, would not be exempt. In the *Hassett* case it does not appear whether or not the hospitals with which the organization contracted for treatment of its members were classified as charitable corporations. It would make no difference. The organization being of the nature of a mutual benefit association is not exempt. The method of operation of the contracting hospitals cannot affect the contracting corporation's taxable status. So, too, we submit that in this case the taxpayer is of the nature of a mutual benefit association. It was not organized or operated exclusively for charitable purposes. Its earnings inure to the benefit of its individual members. Therefore, even if the hospital were operated solely as an eleemosynary institution it would be of no moment, and the Society, as such, would not be entitled to the tax exemption it claims.

II.

CONGRESS DID NOT INTEND TO EXEMPT ORGANIZATIONS LIKE THE TAXPAYER AS CHARITABLE INSTITUTIONS.

The District Court held (R. 37):

> A non-profit hospital which has no stock and pays no dividends renders a public service, and I think Congress has clearly shown its intent to exclude such hospitals from the provisions of the Act.

The court referred to the opinion of the Attorney General dated November 2, 1943, addressed to the President, 40 Op. A.G. No. 72, wherein it was held that the legislative history clearly shows that the language of the exemption statute was adopted by Congress with knowledge that it had been construed to exclude non-profit hospitals. We do not disagree with the opinion of the District Court in this regard. But we emphasize that the scope of the Attorney General's opinion is confined to *non-profit hospitals*. It does not cover organizations like the French Society whose members receive medical care either at, or outside of the hospital, and the earnings of which inure to the benefit of members.

Before discussing the Attorney General's opinion we invite the court's attention to the following extract from the opinion of the California District Court of Appeal case, which we believe clearly demonstrates that Congress did not intend to exempt corporations of the character of the French Society (pp. 546-547):

> Further, we are unable to agree with appellant as to the view, purpose and intent of Congress, that hospitals not operated for profit are charita-

ble institutions. In the *Hassett* case, an action to recover taxes alleged to have been illegally collected under certain provisions of the Social Security Act on the ground that the corporation was operated exclusively for charitable purposes by reason of the fact that its earnings did not inure to the benefit of shareholders or individuals, the court (pp. 615-616) said: "That Congress did not intend organizations similar to the plaintiffs to be considered corporations organized and operated exclusively for charitable purposes is borne out by an examination of the statutes. The section of the Social Security Act here involved is exactly the same as Section 101 (6) of the Revenue Act of 1934, 26 U.S.C.A. Int. Rev. Code, sec. 101 (6), dealing with exemptions from income taxation. The income tax law, however, differs from the social security law in one important respect. In addition to the exemption granted to corporations organized and operated exclusively for charitable purposes, it also grants exemptions to certain types of mutual savings banks; fraternal beneficial societies; cooperative building and loan associations and banks; cooperative cemetery companies; benevolent life insurance associations of a purely local character; mutual ditch and irrigation companies; mutual or cooperative telephone companies or like organizations; farmers' or other mutual hail, cyclone, casualty or fire insurance companies or associations; farmers', fruit growers' or like associations organized and operated on a cooperative basis; voluntary employees' beneficial associations providing for the payment of life, sick, accident or other benefits to the members of such associations or their dependents; and teachers'

retirement fund associations. None of these specific exemptions is contained in the Social Security Act. The fact that Congress specifically mentioned these organizations, even though the statute contained the exemption granted to corporations organized and operated exclusively for charitable purposes, would seem to indicate that Congress did not consider these organizations specifically mentioned to be within the scope of a charitable organization. Since the plaintiff closely resembles many of the organizations specifically exempted, Congress could not have intended it to fall within the scope of a corporation organized and operated exclusively for charitable purposes."

A. The Attorney General's opinion does not apply to organizations of the character of the taxpayer.

It is the contention of the Government that the opinion of the Attorney General does not apply to organizations of the character of the taxpayer but that it is confined to the operation of non-profit *hospitals.*

The opinion follows:

November 2, 1943.

The President.

My Dear Mr. President: I have the honor to refer to your memorandum of August 16 with which you transmitted a letter of the Acting Administrator of the Federal Security Agency requesting my opinion whether services performed for Maynard Hospital, Inc., of Seattle, Washington, are excepted from the definition of "employ-

ment'' in section 209(b) of the Social Security Act, as amended.

This question arises under Title II of the Social Security Act, as amended (49 Stat. 620, 622; 53 Stat. 1360, 1362), which deals with Federal Old-Age and Survivors Insurance Benefits. This title is administered wholly by the Social Security Board. On the other hand, the taxing provisions of the Social Security Act (Federal Insurance Contributions Act; Internal Revenue Code, sec. 1400 *et seq.,* as amended) are administered by the Bureau of Internal Revenue, under the direction of the Secretary of the Treasury.

Paragraph 8 of section 209 (b) of the Social Security Act excepts from the definition of ''employment'' service performed in the employ of a ''corporation * * * organized and operated exclusively for * * * charitable * * * purposes * * *.''

Section 1426 (b) (8) of the Internal Revenue Code (Federal Insurance Contributions Act) provides for exactly the same exemption from ''employment'' as that contained in section 209 (b) (8) of the Social Security Act. Also, these provisions are identical with section 101 (6) Internal Revenue Code, relating to exemptions from income taxes, which statute is administered by the Bureau of Internal Revenue.

It is unnecessary here to set forth the facts in detail. It is sufficient to say that Maynard Hospital, Inc., was organized under the laws of the State of Washington as a non-profit, charitable organization. The Board has determined, on the facts developed in hearings held, that the hospital

is not in fact organized and operated exclusively for "charitable purposes" and has ordered the wages of an employee of the hospital to be credited to her on the wage records of the Board.

Thus, the Board has already decided the matter and proceeded in accordance with that decision. Under such circumstances, the courts ordinarily give weight to an administrative construction of a statute and will not overrule it unless clearly wrong, or unless a different construction is plainly required. * * *

If I should conclude that the Board is wrong the wage earner involved would be entitled under the statute to take her case to court. An opinion, if rendered by me, would not be binding upon private parties or the courts. Also, this Department would be charged with the defense of any court action or actions brought by employees. Under such circumstances, it has been the uniform rule of the Attorneys General to decline to render an opinion. * * *

But in the present case the Bureau of Internal Revenue has held that the services rendered to Maynard Hospital, Inc., are exempt from the term "employment" and that the hospital is not subject to tax under section 1426 (b) (8) of the Internal Revenue Code. These conflicting interpretations made by the Board and by the Bureau of Internal Revenue of identical language in these two closely related statutes, if adhered to, would result in giving employees of the hospital the benefit of the statute without collection of the corresponding tax.

The Secretary of the Treasury has not requested my opinion on the question nor has he joined in the request of the Social Security Board. Investigation discloses, however, that the Bureau of Internal Revenue's interpretation of the statute is in accord with its interpretation of similar language contained in the income tax law, which interpretation was made some years prior to the enactment of the Social Security Act, and apparently has been consistently followed.

In addition, the legislative history of the Social Security Act shows that the conferees eliminated a specific amendment exempting hospitals as surplusage on the ground that the language in the income tax law, identical with that contained in the House bill, has been uniformly construed by the Bureau of Internal Revenue as exempting hospitals not operated for profit, "and also on the fear that the insertion of the words added by the Senate amendment might interfere with the continuation of the long-continued construction of the income-tax law." H. Rept. 1540, 74th Cong., 1st sess., p. 7. Thus, the history clearly shows that the language of the exemption in the statute was adopted by the Congress with knowledge that it had been construed to exclude nonprofit hospitals. This, I think, demonstrates congressional approval of that construction and evidences the intention that the exemption in the Social Security Act should receive the same construction.

In view of the above, I feel constrained to advise the Board to abandon its interpretation and

to adopt one in accord with that made by the Bureau of Internal Revenue.

Respectfully,

Francis Biddle.

The opinion must be considered in the light of the question that was submitted to the Attorney General which was simply whether or not a non-profit hospital should be classified as an exempt charitable institution for social security tax purposes. Maynard Hospital, Inc., was not a society of persons banded together for the benefit of the members. It did not resemble a mutual benefit society. There is no showing that any group had a right under contract or otherwise to treatment or hospitalization at a rate less than that charged to others. The vital question as to whether or not there was, or could be, inurement of benefit to any private shareholder or individual was not presented to the Attorney General. The opinion makes no reference to the phrase "no part of the net earnings of which inures to the benefit of any private shareholder or individual." (In all of those respects, and in other details, the question presented to the Attorney General differs from this case.) Accordingly, we submit that the opinion has no application to the present case.

CONCLUSION.

We submit that the taxpayer is not a corporation organized and operated exclusively for charitable purposes, no part of the net earnings of which inures to the benefit of any private individual. The court below, in holding to the contrary, was in error and its judgment should be reversed.

Dated, September 5, 1945.

Respectfully submitted,

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(Appendix Follows.)

Appendix.

Appendix

Internal Revenue Code:

SEC. 1426. DEFINITIONS.

When used in this subchapter—

* * * * * * *

(b) *Employment.*—The term "employment" means any service of whatever nature, performed within the United States by an employee for his employer, except—

* * * * * * *

(8) Service performed in the employ of a corporation, community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual;

* * * * * * *

(26 U.S.C. 1940 ed., Sec. 1426.)

The above section corresponds to Section 1607(c)(7) of the Internal Revenue Code, Section 811(b)(8) of Title VIII of the Social Security Act, c. 531, 49 Stat. 620 and Section 907(c)(7) of Title IX of the Social Security Act.

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS.

The following organizations shall be exempt from taxation under this title—

* * * * * * *

(6) Corporations, and any community chest, fund or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation;

* * * * * * *

(8) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes;

* * * * * * *

Treasury Regulations 106, promulgated under the Federal Insurance Contributions Act:

SEC. 402.215. *Religious, charitable, scientific, literary, and educational organizations and community chests.*—Services performed by an employee in the employ of an organization of the class specified in section 1426 (b) (8) of the Act are excepted.

For purposes of this exception the nature of the services performed is immaterial; the statutory test is the character of the organization for which the services are performed.

In all cases, in order to establish its status under the statutory classification, the organization must meet the following three tests:

(1) It must be organized and operated exclusively for one or more of the specified purposes;

(2) Its net income must not inure in whole or in part to the benefit of private shareholders or individuals; and

(3) It must not by any substantial part of its activities attempt to influence legislation by propaganda or otherwise.

Corporations or other institutions organized and operated exclusively for charitable purposes comprise, in general, organizations for the relief of the poor. The fact that an organization established for the relief of indigent persons may receive voluntary contributions from the persons intended to be relieved will not necessarily affect its status under the law.

An educational organization within the meaning of section 1426(b)(8) of the Act is one designed primarily for the improvement or development of the capabilities of the individual, but, under exceptional circumstances, may include an association whose sole purpose is the instruction of the public, or an association whose primary purpose is to give lectures on subjects useful to the individual and beneficial to the community, even though an association of either class has incidental amusement features. An organization formed, or availed of, to disseminate controversial or partisan propaganda is not an educational

organization. However, the publication of books or the giving of lectures advocating a cause of a controversial nature shall not of itself be sufficient to deny an organization the exemption, if carrying on propaganda, or otherwise attempting, to influence legislation form no substantial part of its activities, its principal purpose and substantially all of its activities being clearly of a nonpartisan, noncontroversial, and educational nature.

Since a corporation or other institution to be within the prescribed class must be organized and operated exclusively for one or more of the specified purposes, an organization which has certain religious purposes and which also manufactures and sells articles to the public for profit is not within the statutory class even though its property is held in common and its profits do not inure to the benefit of individual members of the organization.

An organization otherwise within the statutory class does not lose its status as such by receiving income such as rent, dividends, and interest from investments, provided such income is devoted exclusively to one or more of the specified purposes.

So far as material to this case, the above corresponds to Section 403.215 of Regulations 107, promulgated under the Federal Unemployment Tax Act; Article 206(7) of Regulations 90, promulgated under Title IX of the Social Security Act; Article 12 of Regulations 91, promulgated under Title VIII of the Social Security Act.